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The Manufacturers Hanover
Financial Digest
Economic Commentary, Selected Financial Data, and Business Indicators

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Although Real GNP Growth Slowed . . .

At first glance, the recent report on real gross national product (GNP) growth in the second quarter seems to point to a considerable slowdown in business activity. According to the Commerce Department, the nation's inflation-adjusted GNP expanded at an anemic 1.1 percent seasonally adjusted annual rate in the April-June period, not only well below the revised 3.8 percent growth rate posted in the first quarter, but also the slowest rate of rise since the final quarter of the 1981-82 recession. But, as is often the case, first appearances can be deceiving. A look beneath the surface of the top-line GNP number reveals an economy actually much stronger than it looks.

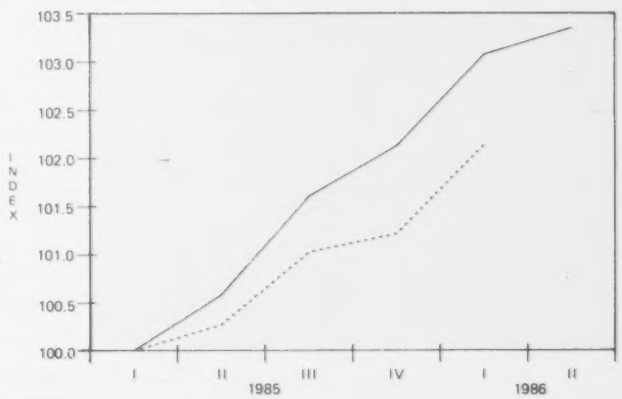
For one thing, the past performance of the economy was far better than many had thought. Upward revisions to real GNP in 1985 and the first quarter of 1986 boosted the level of output in the January-March period by more than $32 billion (see chart). For another, the slow growth pace of the second quarter reflected more changes in inventory spending and in the trade deficit, rather than any decided weakening of the economy. For when the effects of both a diminished pace of inventory accumulation, especially by auto retailers who were in the process of liquidating stocks, and the widening trade deficit are netted out of the GNP numbers, the pace of second quarter economic growth vaults from the reported 1.1 percent to a much healthier 5.5 percent annual rate.

This measure of economic activity—real final domestic demand, or real GNP minus net exports and the change in business inventories—reveals an economy which strengthened considerably in the second quarter, despite widespread perceptions to the contrary. Its annualized advance of 5.5 percent in the April-June period compares with a 1.9 percent decline in the first quarter—and is one and a half times the average rate of rise posted in the preceding five quarters. Consumer spending was the primary force driving this economic growth. Real consumption expenditures rose at a hefty 5.9 percent annual rate in the second quarter—the strongest gain in two years.

. . . A Look Beneath The Surface . . .

Despite this upturn in consumer spending, rising imports and a slower rate of inventory accumulation prevented strong domestic demand from being translated into healthy GNP growth last quarter. Although the value of the dollar has declined by more than 30 percent on a trade-weighted basis since February 1985, real imports soared more than 20 percent at an annual rate quarter-over-quarter, suggesting that the dollar's decline has yet to decrease significantly the proportion of U.S. demand

REVISED REAL GNP (LINE)
VS. UNREVISED REAL GNP (DOT)
(FIRST QUARTER 1985=100)



being satisfied by foreign producers. Because of this deflection of a sizable chunk of domestic demand abroad, and an only modest three percent increase in exports, the inflation-adjusted net export deficit in the GNP accounts deteriorated by $20.4 billion in the second quarter compared with the first—a new record, which subtracted 2.2 percentage points from real growth. In other words, if the U.S. net export position in the second quarter had remained unchanged from the previous quarter, then GNP in the second quarter would have grown 3.3 percent.

While the growth-suppressing effects of the trade deficit were large, a reduction in the pace of inventory spending in the second quarter also was a major influence retarding GNP growth. The $19.6 billion increase in inflation-adjusted business inventories in

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the April-June period marked a significant deceleration in spending compared with the $40 billion accumulation pace of the previous quarter. Much of this reflected efforts of the auto retailers to work down hefty stocks of cars which had piled up prior to the latest round of dealer-financing incentives. This slowdown in inventory spending reduced the level of real GNP in the second quarter by more than $20 billion, subtracting 2.2 percentage points from the second quarter's growth rate.

. . . Reveals A Stronger Economy

These changes in inventory spending and net exports, and their significant effects on output, can be seen by comparing the economic trends of last quarter with those of the first, when real GNP posted a 3.8 percent annual rate of gain. Output growth in the first was boosted by the narrowing of the net export deficit and a substantial rise in the rate of inventory accumulation. Therefore, when the GNP-boosting effect of the hefty, and largely involuntary, buildup in inventories and improvements in our net export position are netted out, a somewhat different picture emerges for the January-March period: The first quarterly drop in inflation-adjusted final domestic demand since the onset of the current business expansion at the end of 1982.

Although the second quarter's GNP growth rate tended to mask the strength of final sales, and

Selected Federal Reserve Data

(Averages of Daily Figures—Billions of Dollars)

	Week Ending 7/30/86	$ Change Since Week Ago	$ Change Since Year Ago
Reserve Bank Credit			
U.S. Gov'ts and Agencies Owned Outright & RPs	192.383	– .534	+17.467
Loans to Depository Inst.	.746	+ .088	– .204
Float	.608	+ .223	– .012
Total Reserve Bank Credit	209.795	+ .500	+20.619
Treasury Deposits with Federal Reserve Banks	3.862	+ .229	+ .137
Currency in Circulation	199.655	– .804	+13.095
Gov'ts held for Foreign Acct. by F.R. Banks (End-of-Week)	151.639	– .053	+25.996
	7/30/86		
Member Bank Reserves:			
Total Reserves Held	49.953	– .894	+ 7.529
Excess (Deficiency)	1.182	+ .484	+ .229
Net Free Reserves	.774	+ .392	+ .232
		% Change Since Three Months Ago*	% Change Since Year Ago
Monetary Aggregates †			
M1 (7/21/86)	677.7	+ 18.5‡	+ 13.1‡
M2 (June '86)	2,668.9	+ 12.0	+ 7.7
M3 (June '86)	3,322.5	+ 7.6	+ 7.3
Domestic Nonfinancial Debt (1st Q'86)	7,033.5	+ 8.7	+ 14.2

†Seasonally adjusted.

*Seasonally adjusted annual rate.
‡Four-week moving average.

New York Money Market

Offering Rates 8/1/86	3 Months	6 Months	1 Year
‡U.S. Treasury Bills	5.76%	5.76%	5.77%
* Federal Agencies	6.04	5.94	5.93
* Municipal Notes—High Grade (46% Taxable Equivalent)	8.15	8.33	8.89
Negotiable Time CDs Manufacturers Hanover	Rates By Arrangement		
* Secondary Market—Prime	6.23	6.23	6.30

‡Finance Company Paper—Prime

5- 14 days	6.28%
15- 29 days	6.28
30- 59 days	6.28
60- 89 days	6.23
90-179 days	6.15
180-239 days	6.00
240-270 days	6.00

‡* Bankers' Acceptances

Sep.	6.16%
Oct.	6.13
Nov.	6.10
Dec.	6.08
Jan.	6.05
Feb.	6.03

‡Industrial Paper—Prime

30- 89 days	6.22%
90-120 days	6.14

†Federal Funds Effective Rate 6.35%

‡Discount basis. * Subject to availability. † Estimated.

Selected Business Indicators

(All Dollar Figures in Billions)

	Latest Period or End of Period		Previous Period	Year Ago Period
Gross National Product (Current Dollars)*	2nd Q'86n	$ 4,182	$ 4,149r	$ 3,965r
Gross National Product (1982 Dollars)*	2nd Q'86n	$ 3,666	$ 3,656r	$ 3,568r
Percent Change, Annual Rate	2nd Q'86n	1.1	3.8r	2.3r
Change in Consumer Prices*	Jun '86n	6.0%	2.4%	2.4%
Change in Producer Prices*	Jun '86	0.0%	7.2%	– 2.4%
Civilian Employment (Thousands of Persons) †	Jul '86n	109,882	109,673	106,871
Unemployment as % of Civilian Labor Force †	Jul '86n	6.9%	7.1%	7.3%
Personal Income*	Jun '86n	$ 3,479	$ 3,476r	$ 3,305r
Leading Indicators Composite Index (1967=100)†	Jun '86n	178.6	178.1r	167.7
Industrial Production Index (1977=100) †	Jun '86	124.1	124.7	124.3
Net Change in Consumer Installment Credit †	May '86	$ 5.39	$ 4.30	$ 6.33
U.S. Merchandise Trade Balance	Jun '86n	–$ 14.17	–$ 13.12r	–$ 10.50
Plant and Equipment Expenditures*	3rd Q'86	$388.87(a)	$387.42(a)	$388.90
Private Housing Starts (Thousands of Units)*	Jun '86	1,845	1,860	1,693
New Construction Expenditures*	Jun '86n	$ 375.1	$ 374.9r	$ 352.9
Total Business Inventories †	May '86	$ 586.6	$ 588.6	$ 577.8
Total Business Sales †	May '86	$ 420.7	$ 428.5	$ 424.4

*Seasonally adjusted annual rate. †Seasonally adjusted. n-Newly reported figure. r-Revised. a-Anticipated.

especially consumer spending, one does not have to look far to find soft spots in business activity. The continued leakage of domestic demand abroad is hurting the goods-producing sector, and the plunge in energy prices is putting the squeeze on the oil and gas industry. As a result, industrial production has declined four times in the past five months and is no higher now than its level a year ago. Reduced production, in turn, has led to layoffs in manufacturing industries which have lost almost 160,000 jobs since the beginning of this year alone.

This burden has caused a sharp division in employment patterns between those sectors which produce goods and those which provide services. While the manufacturing sector has failed to make up for the jobs lost in the last recession, service-providing industries, which are barely affected by import competition, are thriving. This dichotomy fits the general pattern of an economy split between a strong consumption side and a weak production side. Nor is it expected to change any time soon. While the workdown of inventories could set the stage for a modest snapback in production in the current and in subsequent quarters, no major reduction appears likely in the growth-inhibiting effects of the trade deficit until the dollar weakens further and economic activity picks up abroad (Financial Digest—July 21, 1986).

Short Term Paper Outstanding

(Millions of Dollars)

	Latest Week	Change Since Week Ago	Change Since Year Ago
Time Deposits of $100,000 or more Weekly Reporting Banks			
Nationwide (7/16/86)	152,302	+ 566	– 944
New York City (7/23/86)	33,463	– 448	+ 787
Commercial Paper (7/23/86)	315,363	– 1,342	+50,554

Bank Loans

(Millions of Dollars)

Commercial and Industrial Loans

Weekly Reporting Large Commercial Banks	Latest Week	Change Since Week Ago	Change Since Year Ago
Nationwide (7/16/86)	257,504	– 1,469	+ 3,090
New York City (7/23/86)	55,550	– 490	– 4,088

Total Loans and Leases Gross Adjusted

	Latest Week	Change Since Week Ago	Change Since Year Ago
Nationwide (7/16/86)	740,155	– 610	+ 53,956
New York City (7/23/86)	157,281	– 2,582	+ 11,073

Financial Markets

	Friday 8/1/86	Change Since Week Ago	Change Since Year Ago
U.S. Governments, Closing Yields:			
90-Day Bills†	5.91%	– .03	– 1.62
180-Day Bills†	6.00	– .10	– 1.88
Longest Bills†	6.11	– .14	– 2.11
Recent Issues:			
6⅝s 7/31/86	6.52	– .12	
7¼s 6/30/90	6.91	– .11	
7⅜s 5/15/96	7.33	– .01	
7¼s 5/15/16	7.46	+ .06	
Municipals:			
Bond Buyer–20 Bond Index* (7/31/86)	7.54%	– .06	– 1.47
Blue List Total ($ Million)	$2,276	–$ 116	+ $ 186
30-Day Visible Supply ($ Million)	$4,653	–$1,368	+ $1,705
Total	$6,929	–$1,484	+ $1,891
Corporates:			
Moody's Aa Composite (7/31/86)	9.31%	– .02	– 2.22
30-Day Visible Supply ($ Million)	$3,550	+$ 260	+ $ 97
Stocks:			
Dow-Jones Averages:			
Industrials	1,763.64	– 46.40	+ 410.59
Transportation	713.00	– 7.50	+ 13.56
Utilities	203.28	– 4.17	+ 46.43
65 Stocks	682.86	– 1.45	+ 123.46
N.Y.S.E. Composite Index	135.29	– 3.12	+ 24.44
N.Y.S.E. Avg. Daily Vol. for Week (000's)	123,630	– 5,309	+ 17,102

* 46% Taxable equivalent 13.96%.

† Bond equivalent.

International Rates

EURODOLLAR DEPOSIT RATES (bid)	Friday 8/1/86	Week Ago
Overnight	6.31%	6.25%
1 month	6.38	6.50
3 month	6.38	6.50
6 month	6.38	6.50
1 year	6.44	6.63
EURODOLLAR BONDS		
Average Yield		
Medium Term (5 to 7 yrs.)	7.67%	7.64%
Long Term (7 to 15 yrs.)	8.24	8.21

FOREIGN EXCHANGE SPOT RATES

New York Opening (8/1/86)	U.S. $ Equivalent	Currency Per U.S. $
Belgium	.02320	43.10
Canada	.7245	1.3803
Denmark	1268	7.8865
France	.1474	6.7825
Germany	.4791	2.0872
Italy	.0006976	1433.55
Japan	.006498	153.90
Mexico	.001550	645.00
Netherlands	.4244	2.3560
Switzerland	.5988	1.6700
U.K.	1.4899	.6712

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